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## **SECTION II: OPERATIONS AND FINANCE**

### **Chapter 4 - BUDGET**

An association must have sufficient funds to cover the costs of properly maintaining the common areas and facilities, planning for future growth needs of the community, and carrying out its administrative and other responsibilities. A budget estimates these costs and, at its most elementary level, is used to balance income and expenditures to guard against overspending. A budget is also a planning tool to achieve the objectives and priorities of an association and to plan for its likely expenses on an annual and multi-year basis. It assures association members that their assessments are justified and that the money is wisely spent for both the needs and desires of the association. This chapter discusses the factors to consider when preparing a budget; e.g., the association income and expenses, facility and equipment inventories, and the establishment of reserves for general operations and capital projects.

Much of the maintenance and services provided by an association are required by its documents. Frequently, however, an association has discretion over the level of service or maintenance provided; e.g., it can maintain its lawns to give a “country club” look, or it can maintain them at a “neat and presentable” level. Many associations also provide optional services such as social, educational and sports programs, the number and extent of which depends on the desires and participation of the association members. The board of directors is ultimately responsible for fiscal management, making sure that the association’s obligations are adequately fulfilled, and that proper value in service is received for each expenditure.

The process of drawing up a budget is an opportunity to evaluate the quality and quantity of the services provided and to determine whether they should be maintained, upgraded, reduced, or eliminated. It is also an opportunity to reflect owners’ needs, preferences and priorities. To accomplish this, an association can perform resident surveys, have its committees hold meetings or hearings to discuss the committee’s area of responsibility, or hold a general budget hearing for comment on the entire proposed budget. Even if the budget is not subject to member approval, a budget hearing can provide the board an opportunity to inform owners of the needs of the association, the reasons for budgeted items, and how budget figures are derived.

#### **Budget Preparation:**

The time required for preparation of an annual budget depends upon the variety of services provided by the association and the number of persons who are involved in the preparation process. Regardless of whether the budget is prepared by the treasurer, manager, finance committee or a cooperative effort of all, the association should establish a budget schedule and provide general directions to guide the preparers. A budget schedule can be established by working backward from the date the association’s new fiscal year begins and allowing time for committee work, budget hearings, final approval of the budget and proper notice to members of the annual assessment. Seldom will an association begin preparation of an annual budget without background materials to work with. The previous year’s budget, existing contracts, bills and vouchers, a set of books showing income and expenditures, and financial statements will help to formulate a budget for the upcoming year. The association must

determine the mandatory responsibilities that result in the expenditure of funds, its authority to spend funds for non-mandatory activities, and any limitations placed on the association in establishing assessment levels.

Project Inventory - If an association does not have a detailed inventory of all land, facilities and improvements in the community, an inventory should be prepared that lists the area of common grounds parcels and facilities and/or improvements thereon. A site plan can be obtained from the Department of Public Works and Environmental Services Plan Control Section at (703) 324-1810, and the square footage of lawn, sidewalk, streets, and facilities can be measured and calculated. Preparation of an inventory is time consuming but just once is usually sufficient to provide the association with accurate data to use in estimating budget-related expenses. Sample inventory work sheets are included at the end of this chapter to assist in determining maintenance needs and responsibilities of the association.

An inventory of equipment, furniture and other association property should also be made, including the age, cost, condition and supplier of each item, and all current warranties and guarantees. This is necessary to determine insurance needs and asset values. Once the association identifies its maintenance and service responsibilities and its property and equipment condition, it is in a better position to budget the expenses that are likely to be incurred in operating the association for the coming term.

Income - An association's principal source of income is the assessments paid by the owners. Other miscellaneous income sources may include: fees for late payment of assessments, guest fees for use of recreational facilities, newsletter advertising, vending machine profits, profits from social functions, interest on reserve funds, etc. If interest income on reserves is dedicated to the reserve funds, and advertising income from a newsletter is used exclusively to offset the cost of producing it, these revenues need not be considered income for budget purposes. If other sources of income are reasonably stable, they can be included in the association's income projection for the coming year.

When anticipated expenses are known, the income that must be obtained from assessments can be determined. If additional income is needed, the budget should be reviewed to make certain nothing can be cut prior to levying an assessment increase. If assessment income exceeds the budget requirements, the budget should be examined to make sure all expenses are included and that reserve funds are properly allocated. An association experiencing a pattern of uncollectible assessments may want to add a factor to ensure coverage of budgeted expenses. It is desirable to eliminate or reduce, rather than tolerate, uncollectible assessments; but the budget should reflect that they exist. An association's documents usually establish the initial assessment for each unit based on the developer's projected expenses for maintaining the common areas and managing the association. It may be advisable to work with the developer to set the amount at a level appropriate for the owners after they take control of the association. Additionally, the documents will outline the basis on which the amount of the assessment on each unit is determined, the amounts by which the assessment can be increased each year without a

vote of the members, the procedures to be used to increase the assessment above this amount if necessary, and the procedures for notifying the owners of the amount of the assessment. In some associations, the documents prohibit assessment increases above a specific amount, while others are limited by a maximum percentage increase. In either situation, an association may want to amend the documents to permit raising sufficient funds for satisfactory operation of the association.

Expenses - Chapter 5 discusses the expenses most frequently incurred by community associations. Regardless of who prepares the expense section(s) of the budget, it is important that each proposed expenditure reflects a comparison with past budgets. This should include a review of bills, contracts and vouchers related to the budget item, particularly where renewals are set for a time during the budget year. The effects of inflation on labor and materials should also be considered as well as the effects of any proposed change in the level or frequency of a service. Some changes may be unanticipated, such as increases in governmental service fees or charges, or unusually high utility expenses. Operating reserves are set in the budget to handle these as discussed in more detail in the section on reserves. Proposed physical improvements, reserve fund expenditures or other discretionary spending should be listed in a separate section of the budget.

Budget Format - An association's budget reflects the number and types of services it provides, and the format of the budget should be tailored to meet each association's needs. The two most common types of budgets are line item budgets and program budgets. A line-item budget lists expenses by type; i.e., salaries, supplies, etc. Associations with few administrative and maintenance costs may find that a simple line-item budget listing income, expenses, and reserves fulfills its budget needs. A program budget lists expenses according to the purpose for which they are incurred (e.g., administration, maintenance, playground operation) and reflects the cost of a service or facility more accurately than a line-item budget, because it shows all expenses associated with each service or facility. Associations that provide many types of services may find it advantageous to use a program budget or modified program budget to list its expenses. A program budget uses expense categories to list related expenses in detail. Normally these categories are also used to designate expenses in all of an association's record keeping.

Financial management of homeowners' and condominium associations almost always utilizes some combination (or all) of the following expense categories: 1) administrative-management fees, office supplies, furniture, computer systems, taxes, and insurance; 2) operating expenses- land services and grounds maintenance, snow removal, property inspections, reserves, swimming pools, community centers, and community programs, painting, and maintaining recreational facilities; 3) unit services- utilities, trash collection, unit reserves newsletter and/or other communications. The Financial and Accounting Guide for Non-Profit Organizations (see Bibliography) and other publications as well as knowledgeable and experienced accountants are available to assist

with the development of a thorough and comprehensive budget format customized for an association's specific needs. When presenting a budget to the members of an association for preliminary information and input or for approval, it can be helpful to break out the items in the budget by cost per unit per month or quarter to show members exactly how their money is being spent. It is also advisable to include explanatory notes or a commentary with the budget to let members know how various figures were derived.

Capital Reserves - One of the major financial responsibilities of an association is the establishment of reserve funds to cover the cost of anticipated renovations, major repairs, and replacements for capital facilities. Reserves are generally included in the budget as an expense item. The documents of many associations, particularly for condominium developments, require that reserves be established and maintained for the repair and replacement of association facilities that have a life expectancy less than the buildings (i.e., roofs, heating/cooling systems, streets, swimming pools, etc.). Various mortgage-lending institutions require that reserves be established and maintained. Failure to establish reserves may require that an association must drastically increase its annual assessment, levy a special assessment, borrow money, or just not repair (often not an option) when faced with the expense of a major repair.

It is not unusual for an association to have difficulty convincing its members of the need for accumulating adequate reserve funds. In transient areas, members who do not expect to live in the community for an extended period are often opposed to funding improvements from which they are not likely to benefit. It can be shown that established reserve funds assist owners in selling their homes by providing evidence that prospective purchasers will not have to bear the primary costs for the replacement of common facilities they did not help wear out. One of the major problems in establishing and maintaining reserves is determining the amount that should be set aside to provide for future expenses. While it is impossible to know specifically the nature, extent and timing of replacement or major repairs for various items, general guidelines can be established which reflect the major expenses that can be anticipated by a facility over its lifetime. Contact with contractors and manufacturers can provide an idea of the costs associated with these anticipated repairs which can be used until experience provides more accurate data.

A generally accepted way to establish reserves is to determine the replacement or renovation costs of each major association facility or improvement (including a cost inflation factor), divided by the number of years until the replacement or renovation is expected, and set that amount aside each year. An association may also contract with an architect/engineering firm for a repair/renovation study of association facilities, and to include a projected schedule of repairs and renovations and estimated costs. If permitted by the documents, the board of directors might invest accumulated reserves in a long-term growth investment with greater earning power than a savings account. In this case, the board should seek professional advice and be fully aware of the investment risks to the association's funds.

In addition to eventual replacement or renovation, some facilities will require major maintenance during their useful life. Reserves should also be set aside for these expenses. For example, while reserve funds for a tennis court are often based on the cost of renovating the court after 20-25 years, a major expense for resurfacing and repainting the court will be incurred every 6-8 years. If this expense is not included as an operating expense and these expenditures are deducted from the renovation reserve, sufficient funds will not be available to cover the renovation when it is needed.

In 2002, the Virginia General Assembly enacted amendments to the Property Owners Association Act and the Condominium Act that requires every association to conduct a reserve study at least once every five years, and to review the most recent study at least every year. The purpose of these requirements is to force the respective boards to stay current with their association's real maintenance and replacement needs and costs, and to prevent falling behind and requiring a special assessment to cover their negligence. Inflation increases all costs but material costs often increase more rapidly than the rate of inflation (e.g., petroleum-based materials fluctuate more closely with crude oil prices on the world market than with the local economy). The anticipated time frame for major repairs can also change with mild or severe weather, the effects of proper maintenance or no maintenance, or variations in the use of a facility that may cause a change in its life cycle. The manner in which reserve funds are established and funded can make a big difference in an association's income tax liability, and should be discussed with an attorney or accountant. Some associations require that reserves be kept in a federally insured institution to limit their use for investment purposes. The placement of reserves for maximum interest or return on investment with minimal loss exposure should be thoroughly discussed by the board.

General Operating Reserves - A general operating reserve, often called a contingency reserve, should be built into the annual budget to cover unanticipated operating expenses and repairs. Older associations and conversion condominiums may find that a larger contingency reserve is necessary than is sufficient for newer constructions. Two to three percent of the operating budget is a typical amount reserved. Unexpended funds from a given year might be added to the association's capital reserve, or be used to reduce the following year's operating reserve.

Special Assessments - Occasionally, expenses cannot be met with normal assessment income and a special assessment must be collected. Special assessments must be allocated to a specific expenditure such as the repair and construction of a capital improvement, if such cost is not already covered by reserve funds. The Virginia Property Owners' Association Act provides the authority to associations to levy special assessments "...to be used primarily for the upkeep and maintenance, including capital expenditures, of the common area." Association officers should be aware of the information on Americans with Disabilities Act (ADA) and the Fair Housing Act (FHA) at the end of Chapter 5, and Directors and Officers Liability in Chapter 6. For most associations, ADA/FHA requirements are likely to be an unplanned, unbudgeted but mandatory and costly improvement to association facilities. Failure to provide such

requirements (and the special assessments that may be necessary for financing) could subject an association and its officers to liability suits and punitive judgments.

Special assessments can be difficult when member approval is required, and serious financial trouble can result if the members defeat a special assessment proposal. Members can rescind or reduce a special assessment at a membership meeting if held within 60 days of promulgation of the special assessment. The board should present adequate justification to the membership that a special assessment is necessary and the costs and consequences of other plans, including a “do nothing” alternative. The board should not commit to spend the money until the membership disapproval time has passed.

## **Project Inventory Work Sheets**

**A. Association Area (Overall)**      -      -      -      -      -      \_\_\_\_\_ Acres

**B. Improved Areas:**

1. Residential Building Area/Lots:

(for each):	(Length)	(Width)	(Total)
a. Length X Width =	_____ x	_____	= _____ sq. ft.
b. Length X Width =	_____ x	_____	= _____ sq. ft.
Total 1. =			_____ sq. ft.

2. Recreation Facilities (for each):

a. <u>Club House</u>	_____ x	_____	= _____ sq. ft.
b. <u>Pool Area</u>	_____ x	_____	= _____ sq. ft.
c. <u>Playground</u>	_____ x	_____	= _____ sq. ft.
d. <u>Other (etc.)</u>	_____ x	_____	= _____ sq. ft.
Total 2. =			_____ sq. ft.

3. Paved Areas (privately owned):

a. <u>Streets:</u>			
(for each)	_____ x	_____	= _____ sq. ft.
	Subtotal a.		= _____ sq. ft.
b. <u>Parking Areas :</u>			
(for each)	_____ x	_____	= _____ sq. ft.
	Subtotal b.		= _____ sq. ft.
c. <u>Sidewalks and Paths :</u>			
(for each)	_____ x	_____	= _____ sq. ft.
	Subtotal c.		= _____ sq. ft.
d. <u>Ball and Tennis Courts</u>			
(for each)	_____ x	_____	= _____ sq. ft.
	Subtotal d.		= _____ sq. ft.
Total 3. =			_____ sq. ft.

4. Paved Areas (Publicly Owned):

a. <u>Streets:</u> (for each)	_____ x	_____	= _____ sq. ft.
	Subtotal a.		= _____ sq. ft.
b. <u>Sidewalks and Paths:</u>			
(for each):	_____ x	_____	= _____ sq. ft.
	Subtotal b.		= _____ sq. ft.
Total 4. =			_____ sq. ft.



**C. Common Green Areas:**

1. Landscaped:  
(for each area): \_\_\_\_\_ x \_\_\_\_\_ = \_\_\_\_\_ sq. ft.  
Subtotal 1. = \_\_\_\_\_ sq. ft.
2. Natural (stream valleys,  
buffers, open spaces) \_\_\_\_\_ x \_\_\_\_\_ = \_\_\_\_\_ sq. ft.  
Subtotal 2. = \_\_\_\_\_ sq. ft.
- Total C. = \_\_\_\_\_ sq. ft.

**D. Fence and Screen:**

1. Pool: \_\_\_\_\_ x \_\_\_\_\_ = \_\_\_\_\_ sq. ft.  
Subtotal 1. = \_\_\_\_\_ sq. ft.
2. Other (Courts):  
(for each) \_\_\_\_\_ x \_\_\_\_\_ = \_\_\_\_\_ sq. ft.  
Subtotal 2. = \_\_\_\_\_ sq. ft.
3. Natural:  
(for each) \_\_\_\_\_ x \_\_\_\_\_ = \_\_\_\_\_ sq. ft.  
Subtotal 3. = \_\_\_\_\_ sq. ft.
- Total D. = \_\_\_\_\_ sq. ft.

**Summary**

**A. Association Area** (total) \_\_\_\_\_ Acres

**B. Improved Areas:**

1. Residential Buildings \_\_\_\_\_ Sq. Ft.  
2. Recreation Facilities \_\_\_\_\_ Sq. Ft.  
3. Paved Areas (privately owned) \_\_\_\_\_ Sq. Ft.  
4. Paved Areas (publicly owned) \_\_\_\_\_ Sq. Ft.

**C. Common Green Areas:**

1. Landscaped (Turf, Gardens, etc.) \_\_\_\_\_ Sq. Ft.  
2. Natural (Stream Valleys, Buffers, etc.) \_\_\_\_\_ Sq. Ft.

**D. Fences and Screens:**

1. Pool \_\_\_\_\_ Sq. Ft.  
2. Natural \_\_\_\_\_ Sq. Ft.  
3. Other \_\_\_\_\_ Sq. Ft.